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OPINION

■ PREDATORY LENDING

Let the states legislate

By David Reiss
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Predatory lending was the most pressing consumer protection issue of 2004. Indeed, the Center for Responsible Lending found that predatory loans cost U.S. families more than $9 billion a year. Predatory lending is particularly rampant in the subprime home equity loan market, where lenders have originated loans worth billions of dollars with abusive terms to unsophisticated borrowers. It is such a serious problem that it looks as if major changes are in store in 2005 for how loans are to be made to homeowners. It is important to decide whether these changes will help or hurt them.

Recently, many states responded to this scourge upon homeowners' equity by enacting predatory lending laws to limit such practices in their own jurisdictions. Large segments of the lending industry opposed these laws, claiming that the resulting regulatory patchwork increases their compliance costs, exposes even the most law-abiding lender to liability and ultimately increases loan costs for consumers.

Partially as a result of these complaints, momentum is building on three fronts to standardize the operations of the subprime mortgage market. First, government-sponsored entities (GSEs) Fannie Mae and Freddie Mac, the two largest purchasers of residential mortgages on the secondary market, indicated that they will not purchase loans with certain terms that they deem to be abusive.

Second, federal regulators already pre-empted the application of state predatory lending laws to a broad array of lending institutions, and Congress is considering legislation to pre-empt their application to the remaining ones that are still regulated by such laws.

And finally, Standard & Poor's, Moody's and Fitch, the three major rating agencies, indicated that they will not rate securities backed by pools of residential mortgages if any of those mortgages violate their rating guidelines relating to predatory lending laws. The lack of a rating from at least one of these agencies is the equivalent of a death sentence for a residential mortgage-backed securities (RMBS) offering—the dominant source of financing for subprime lending overall. The rating agencies' guidelines have typically taken a dim view of predatory lending laws, finding them to be too protective of homeowners at the expense of investors. Not coincidentally, rating agencies make more money in a growing RMBS market; thus, it is in their self-interest to keep states from passing laws that slow secondary market growth and cut into their income. Rating agencies have been successful in pushing state legislatures to dilute predatory lending laws.

Efforts to standardize are still premature.

Advocates for the lending industry often promote the increased standardization of the secondary market as a way to reduce predatory behavior without punishing legitimate lenders. But each of the three methods must be independently evaluated to determine how well it achieves its goals.

First, while the GSEs are private companies, they are federally chartered to provide ongoing assistance to the secondary mortgage market so as to help low- and moderate-income individuals become homeowners. The GSEs must balance their profit-seeking with the effectuation of their public purpose. Because Congress and the media closely monitor them and because they have competitors in the secondary market, the GSEs' incremental approach is likely to do some good: It should reduce the number of loans with abusive terms without effectively vetoing state lending laws.

Second, federal pre-emption in the name of uniformity and predictability in the financial markets is often appropriate, but in the predatory lending context, it is premature. States, playing their traditional role as laboratories for policy experimentation, should be left alone until the relative merits of different approaches to the problem can be compared.

Agencies are not balanced

Finally, rating agencies have no mandate similar to that of the GSEs. While they have been granted a privileged regulatory status by government agencies, they have no reciprocal responsibility to the public. Because there is no adequate way to exercise public pressure on them, their misjudgments interfere with legitimate state policies. Those concerned with homeowners' rights should be more skeptical of the agencies' efforts to impose standardization on the mortgage market through their effective veto of aggressive state predatory lending laws.

As federal legislators and regulators address predatory lending in 2005, it is wise to remember that states have taken the lead and that the rating agencies are most unmoored from legitimate public policy goals in this arena. Legislators and regulators should seriously consider the path forged by the former and view skeptically that prescribed by the latter. NLJ

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